

Royal Construction

Ratings

Facilities	Amount (Rs. in Million)	Ratings ¹	Rating Action
Long Term Bank Facilities	24.89	CARE-NP BB- [Double B Minus]	Assigned
Short Term Bank Facilities	55.00	CARE-NP A4 [A Four]	Assigned
Long Term/ Short Term Bank Facilities	1,450.00	CARE-NP BB-/A4	Assigned
Total Facilities	1,529.89 (One billion five hundred twenty nine million eight hundred and ninety thousands only)		

Details of Facilities in Annexure 1

CARE Ratings Nepal Limited (CRNL) has assigned the rating of 'CARE-NP BB-' to the long term bank facilities and the rating of 'CARE-NP A4' to the short term bank facilities of Royal Construction (ROC).

Detailed Rationale & Key Rating Drivers

The ratings assigned to the bank facilities of ROC are constrained by its fluctuating scale of operations with low capital base and concentrated revenue mix, leveraged gearing levels and working capital intensive nature of operations. The ratings also factor in ROC's presence in highly competitive construction industry coupled with tender based nature of operations, risk of delay in project execution and exposure to volatile interest rates.

The ratings however derive strengths from experienced promoter and established track record of operations, moderate order book position with mid-term revenue visibility, moderate counter party risk and escalation clause in majority of contracts.

Going forward, the ability of the firm to profitably scale up its operations amidst high level of competition and manage its working capital requirements to support growth will be the key rating sensitivities.

Detailed Description of the Key Rating Drivers

Key Rating Weaknesses

Fluctuating scale of operations with low capital base and concentrated revenue mix

The Total Operating Income (TOI) of ROC has been fluctuating over the past three financial years. TOI declined to Rs. 533 Mn in FY22 (Unaudited, FY refers to the twelve-month period ending mid-July) from Rs. 681 Mn in FY21 (Audited) amid lower project execution. Earlier in FY21, the TOI had increased by 29.71% over FY20. Beside fluctuating scale of operations, the profitability margins of the firm were also modest with PBILDT margin at around 6% and PAT margin at around 2% during the period. The firm's revenue base comprises mainly of building construction works (accounting for around 66% of total outstanding order book as on November 27, 2022) received mostly from various government departments. This exposes the firm to revenue concentration risk in terms of business segment.

Furthermore, with relatively low proprietor's capital of Rs. 3.50 Mn as on mid-July 2022, the ability of the firm to scale up larger sized contracts having better operating margins is constrained by its comparatively low capital base. Small scale of operations in a competitive industry could limit the pricing power and benefits derived from economies of scale. The ability of the firm to profitably scale up its operations amidst high level of competition is critical from credit perspective.

¹Complete definitions of the ratings assigned are available at www.careratingsnepal.com and in other CRNL publications.

Leveraged gearing levels amid working capital intensive nature of operations

ROC's overall gearing ratio, including mobilization advance, stood leveraged at 1.85x at the end of FY22. Total debt of the company, which mainly comprises of hire purchase loans, mobilization advance & working capital borrowings, increased in FY22 to Rs. 75 Mn from Rs. 66 Mn at the end of FY21. Furthermore, amid a high non-fund based exposure, ROC's potential gearing remained very high at around 28x at the end of FY22.

The operations of the firm are working capital intensive in nature. ROC primarily works with various government departments and payments for the contracts are generally received only after the completion of work certification process and finalization of bills. Lengthy certification processes normally lead to high work in progress and inventory levels. Although ROC had high creditor's period of 50 days in FY22 on account of long standing relationship with suppliers, the company's financial burden is likely to increase going forward leading to higher borrowing requirements as the company starts to pay off the outstanding payables coupled with increased execution of projects at hand. These factors led to reliance of the firm on bank finance to meet its working capital requirements.

Tender based nature of operations in a highly competitive construction industry

Majority of the ROC's projects are tender-based government contracts (including provincial and local bodies) wherein the company has to quote a bid. With multiple players active in the industry, the firm's business is vulnerable to under bidding at a relatively low cost in order to secure the projects, in the highly competitive construction industry. Furthermore, the business also remains dependent on sustained capital expenditure by the government towards construction projects, overall stability in government policies and fiscal position of the government. Government of Nepal (GoN) has put certain restrictions on the contractors to participate in tenders such as prohibiting foreign companies to participate in tenders having value less than Rs. 3,000 Mn, which augurs well for domestic players. Furthermore, the GoN has also placed a cap on total active projects of construction companies at five, which could limit growth prospects.

Risk of delay in project execution

Given the nature of projects awarded, ROC is exposed to inherent risk in terms of delays in certain projects undertaken by the company due to delay in procedural approvals and clearance of project sites, etc., thus exposing the company towards the risk of delay in projects further resulting a delayed realization of revenue growth. Furthermore, the firm's ability to execute projects in timely manner would be led by its own operational efficiency and timely stage payments received from clients.

Exposure to volatile interest rates

Nepalese banking sector has a floating interest rate regime, where a certain premium is added to the quarterly base rate and interest rate is changed accordingly on quarterly basis. The base rates of the banks and financial institutions (BFIs) in Nepal remain quite volatile as they are impacted by available liquidity in the system which leads to change in interest rates. The volatility in interest rate is more evident currently on account of the ongoing liquidity stress in the economy, with substantial upward pressure on interest rates in the last few quarters. A contractionary monetary policy for FY23 coupled with increasing inflation has only added to the upward pressure on interest rates, resulting in the rate hikes taken by BFIs in the first quarter of FY23. Any further significant rate hikes could put increased interest burden on the company, squeezing its profitability and impacting its liquidity position. Therefore, funding taken by the company from BFIs is subject to volatile interest rate.

Key Rating Strengths**Experienced promoter and established track record of operations**

Royal Construction was established in 2001 by Mr. Prakash Bahadur Shethi, the firm's sole proprietor, who has more than two decades of experience in the field of construction business which bodes well for the overall business prospects of the

company in an increasingly competitive industry. The firm has an established track record of operations in the construction of various infrastructure projects all over Nepal, especially buildings and roads for public entities, local government and provincial government.

Moderate order book position with mid-term revenue visibility

As on November 27, 2022, the unexecuted orders in hand of the company stood at Rs. 1,458 Mn (includes share of ROC through Joint Ventures) which is ~2.73x of its operating income for FY22, providing mid-term revenue visibility. The order book is divided into building and road projects accounting for ~66% and ~33% of the total work outstanding respectively. Timely completion of the projects would be critical for the business prospects of the company and also has a direct bearing on its margins.

Moderate counter party risk and escalation clause in majority of contracts

Revenue of ROC is majorly generated via contracts from government departments including provincial and local bodies. The order book is primarily concentrated towards building construction projects from government departments. Counter party risk remains moderate given the projects are from government departments, which have been making timely payment to the firm in the past. This enables the firm to pass increase in raw material prices to its customers. Ability of the firm to pass increased burden to the customer in a timely manner and improve profitability margins is critical from credit perspective.

About the Company

Royal Construction (ROC) was founded as a sole proprietorship business in September 5, 2001 by Mr. Prakash Bahadur Shethi. The Class 'A' construction firm has been involved for more than two decades in construction of both private and public sector projects, mainly building and road construction works across Nepal. The firm's operations is concentrated mainly in the western region of Nepal, centered at Kailali district.

Financial Performance

For the period ended	FY20 (Audited)	FY21 (Audited)	FY22 (Unaudited)
Income from operations	525	681	533
PBILDT Margin (%)	5.91	6.36	6.91
Overall Gearing (times)	1.27	1.94	1.71
Interest Coverage (times)	9.44	3.16	2.97
Current Ratio (times)	1.09	1.02	1.24
Total Debt/ Gross Cash Accruals	1.89	3.07	3.90

Annexure 1: Details of the Facilities rated

Nature of the Facility	Type of the Facility	Amount (Rs. in Million)	Rating
Long Term Bank Facilities	Fixed Term Loan	24.89	CARE-NP BB-
Short Term Bank Facilities	Fund Based Limits	55.00	CARE-NP A4
Long Term/Short Term Bank Facilities	Non Fund Based Limits	1,450.00	CARE-NP BB-/A4
Total		1,529.89	

Contact us**Analyst Contact**

Mr. Prashiddha Sharma Gaire

Contact No.: +977 9802335865

Email: prashiddhas@careratingsnepal.com

Mr. Santosh Pudasaini

Contact No.: +977 9802312855

Email: pudasaini.santosh@careratingsnepal.com

Relationship Contact

Mr. Achin Nirwani

Contact No.: +977 9818832909

Email: achin.nirwani@careratingsnepal.com

About CARE Ratings:

CARE Ratings Nepal Limited (CRNL) is licensed by the Securities Board of Nepal w.e.f. November 16, 2017. CRNL is supported by CARE Ratings Limited through a technical services agreement to provide technical support in the areas such as rating systems and procedures, methodologies, etc. from CARE Ratings on an ongoing basis. The technical support shall ensure that CRNL has adequate resources to provide high quality credit opinions in Nepal.

Our parent company, CARE Ratings Limited commenced operations in April 1993 and over two decades, it has established itself as one of the leading credit rating agencies in India. CARE is registered with the Securities and Exchange Board of India (SEBI) and also recognized as an External Credit Assessment Institution (ECAI) by the Reserve Bank of India (RBI).

Disclaimer

CRNL's ratings are opinions on credit quality and are not recommendations to sanction, renew, disburse or recall the concerned bank facilities or to buy, sell or hold any security. CRNL has based its ratings on information obtained from sources believed by it to be accurate and reliable. CRNL does not, however, guarantee the accuracy, adequacy or completeness of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information. Most entities whose bank facilities/instruments are rated by CRNL have paid a credit rating fee, based on the amount and type of bank facilities/instruments.

In case of partnership/proprietary concerns, the rating assigned by CARE is, inter-alia, based on the capital deployed by the partners/proprietor and the financial strength of the firm at present. The rating may undergo change in case of withdrawal of capital or the unsecured loans brought in by the partners/proprietor in addition to the financial performance and other relevant factors. CARE is not responsible for any errors and states that it has no financial liability whatsoever to the users of CARE's rating.